Testimony of
Julie M. Cannell

DELMARVA POWER & LIGHT COMPANY
TESTIMONY OF JULIE M. CANNELL
BEFORE THE DELAWARE PUBLIC SERVICE COMMISSION
CONCERNING AN INCREASE IN ELECTRIC BASE RATES
DOCKET NO. 11-___

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1. Q: <u>Please state your name and position, and business address.</u>

A: My name is Julie M. Cannell. I am the president of my own advisory firm, J.M. Cannell, Inc. My business address is P.O. Box 199, Purchase, New York 10577.

2. Q: <u>Please state your educational background and professional qualifications.</u>

A: My firm, J.M. Cannell, Inc., provides investor-related advisory services to electric utility companies and other firms and organizations with an interest in the industry. Prior to establishing my firm in February 1997, I was employed by the New York-based investment manager, Lord Abbett & Company, from June 1978 to January 31, 1997. During my tenure with Lord Abbett, I was a securities analyst specializing in the electric utility and telecommunications services industries; portfolio manager of America's Utility Fund, an equity utility mutual fund, for which Lord Abbett was a sub-advisor; portfolio manager of numerous institutional equity portfolios; and co-director of Lord Abbett's Equity Research Department.

My educational credentials include a B.A. from Mary Baldwin College, a M.Ln. from Emory University, and an M.B.A. from Columbia University. I am also a Chartered Financial Analyst (C.F.A.).

I have been a member of the Wall Street Utility Group, an organization of security and credit rating analysts having an expertise in the utility industry, for over thirty years.

3. Q: **<u>Have you recently testified before the Delaware Public Service Commission?</u>**

A: No. This is the first time I have appeared before the Delaware Public Service Commission (PSC or Commission).

4. Q: **<u>Have you previously testified on the perspective of investors before other utility regulatory commissions?</u>**

A: Yes, I have. I have submitted pre-filed testimony on behalf of investor-owned utilities before Public Service Commissions and Public Utility Commissions in Arizona, Colorado, Connecticut, Kansas, Maryland, Massachusetts, Minnesota, Missouri, Nevada, New Jersey, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, Washington and Wisconsin The details of my participation in regulatory proceedings are provided in Schedule JMC-1.

5. Q: **<u>Have you had additional regulatory experience?</u>**

A: Yes. As a consultant to the Edison Electric Institute (EEI), I was extensively involved between 2004 and 2009 in an ongoing initiative geared toward fostering and improving communications between state regulators and the investment community. This effort has centered on a series of forums held throughout the United States bringing together these two constituencies, sponsored by EEI and facilitated by Gee Strategies' president, Robert Gee, former chairman of the Texas Public Utilities Commission. In addition to helping structure these dialogues, my role was to moderate panel discussions of equity and debt security analysts.

I have also conducted several studies of investor perceptions of regulatory issues. Further, I have written articles addressing the implications for utilities and state regulators of various topical issues, including the current electric industry capital expenditure cycle, and, more recently, the financial crisis.

6. Q: <u>On whose behalf are you providing direct testimony in this proceeding?</u>

A: I am providing Direct Testimony on behalf of Delmarva Power & Light Company (Delmarva or the Company).

7. Q: <u>What is the scope of your testimony?</u>

A: I will address the perspective of investors in regard to the Company's rate proposal and will provide comments on several areas. These areas include: (1) investors' perspective of risk due to the investment commitments currently being undertaken by electric utilities in general and the Company in particular; (2) investors' perception of risk as impacted by current macroeconomic conditions; (3) investors' expectations for a constructive regulatory environment for Delmarva so as to ensure the Company's continued access to the capital markets; and (4) investors' expectations for Delmarva's return on equity (ROE).

8. Q: **<u>What in your experience allows you to provide testimony about investors' perspectives and expectations?</u>**

A: As a securities analyst, I specialized in the electric utility industry and the individual companies comprising it. And as a portfolio manager, I applied that knowledge, along with investment fundamentals, in making investment decisions on behalf of institutions and individual investors. My experience has given me familiarity with the information and tools that investors use in making decisions with respect to expected ROE. Moreover, I have reviewed the various reports of security and credit rating agency analysts, which have addressed the Company and its current regulatory situation. Further, I have familiarized myself with the Company's fundamentals and its planned investment levels.

9. Q: **<u>As an analyst or portfolio manager, did you follow the Company?</u>**

A: Yes, I did, when the Company was still part of Conectiv. While the Company's market capitalization at that time was too small for inclusion in Lord Abbett's portfolios, America's Utility Fund periodically maintained a holding in Conectiv common stock.

10. Q: **<u>Please describe how your testimony is organized.</u>**

A: There are four parts to my testimony.

I. INVESTORS' REQUIREMENTS FOR INCREASED RETURNS IN UTILITY INVESTMENTS.

This section discusses the investment risk of electric utilities; specifically, why the current construction cycle has increased the risk of investing in the industry. It also addresses how regulatory risk has risen due to this higher capital spending.

II. THE MACROECONOMIC ENVIRONMENT.

This section discusses the elevated risk created by the global economic crisis.

III. INVESTORS' EXPECTATIONS FOR RETURNS AND PERCEPTIONS OF THE CURRENT PROCEEDING.

This section focuses on who investors are, how they actually make their decisions, and a review of the investment community's perceptions of the Company and of Delaware regulation. This review is based on a number of recent publications in which investment analysts discuss their perceptions of the Company and its regulatory environment.

IV. INVESTOR EXPECTATIONS FOR ROE FOR DELMARVA.

This section discusses how investors would view the Company's request for an authorized ROE of 10.75%.

I. INVESTORS' REQUIREMENTS FOR INCREASED RETURNS IN UTILITY INVESTMENTS

11. Q: Please explain why the investment community's view of an electric utility's stock is important to the utility and its customers.

A: Electric utilities are in the business of providing their customers with safe, reliable and efficient service. This requires extensive investment in distribution and transmission infrastructure, which makes the electric utility business capital-intensive. Investors provide the capital necessary to maintain and expand a utility's infrastructure, which in turn enables utilities like Delmarva to provide safe, reliable and efficient service to customers.

The terms on which the Company is able to obtain that capital have a direct and measurable impact on customers and the amounts they pay for electric service.

12. Q: Please provide an example.

A: If credit rating agencies such as Moody's Investors Service (Moody's), Standard & Poor's (S&P), or Fitch Ratings (Fitch) believe that the utility's revenues will be diminished by adverse business or regulatory decisions, those rating agencies could lower their credit ratings for the utility, which would raise the cost of debt. Since the cost of debt is a component of the weighted average cost of capital, the increased costs of capital would eventually be passed on to customers in the form of higher rates.

The same is true for equity investors. If individual or institutional investors believe that the return they are offered is too low in light of the risk involved, they will either sell their stock or elect not to purchase the stock, which generally drives the stock price down. Although lower stock prices would appear at first blush to be a concern only to investors, they also affect customers. When a utility has to go to the equity markets to obtain capital, a low stock price requires it to issue more shares of stock to obtain the same amount of money than it would have received for fewer shares if the per share price had been higher. The resulting increase in the number of shares outstanding requires more dollars to be expended toward dividends, resulting in less retained earnings for reinvestment in the company.

The corollary is that when investors believe that they are investing in a company where regulation is fair, consistent and provides a reasonable rate of return, those investors charge less for their capital. When debt and equity investors demand less for their capital, utility rates remain lower and utilities have more ready access to the capital markets. Thus, a utility and its customers have a shared interest in meeting the expectations of investors and credit rating agencies. Regulators share this interest as well, because fair treatment of one utility decreases the costs of capital for all utilities in that regulatory jurisdiction.

13. Q: <u>Are you suggesting that the Delaware Public Service Commission's (PSC or Commission) decisions should be dictated by investors?</u>

A: Not at all. I realize that the PSC must apply the law to the facts that are presented to it and that it must balance the interests of investors and customers. My point is that the Commission's decision on rate of return is not simply a zero-sum game. If the rate of return strikes an appropriate balance between the utility and customers, both benefit. If the rate of return is set too low, both the utility and customers are adversely impacted because the cost of capital increases over the long term.

14. Q: <u>Can you briefly describe your understanding of the applicable legal standard with respect to a utility's reasonable return on equity?</u>

A: Yes. The United States Supreme Court addressed this issue in its *Bluefield*[1] and *Hope*[2] decisions. These decisions held that a public utility is entitled to a return on equity adequate to assure confidence in the financial soundness of the utility, to maintain its credit, and to enable it to attract the capital necessary to operate its business on reasonable terms compared to firms of similar risk.

15. Q: <u>In your testimony, you refer to the expectations of investors with respect to Delmarva's return on equity. Are those expectations consistent with the legal standard you summarized above?</u>

A: Yes. I believe that the investor viewpoint is consistent with consideration of the public good. As I explain elsewhere, both investors and customers benefit when a utility is financially sound, has strong credit, and is able to attract capital on reasonable terms.

16. Q: <u>How has the risk of investing in electric utilities changed in recent years?</u>

A: It has become clear to investors and others that the industry is now in a period of significant capital expenditures. This new construction cycle reflects the need utilities in general have to replace aging infrastructure; to meet new environmental requirements and expectations; to address the need for grid enhancements; to provide technological advancements such as smart grid technologies; and to add new generation resources to meet growing

[1] *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923).

customer needs. The resulting increase in capital expenditures from all of the investments set forth above means that utilities will be more active in capital markets and, therefore, will be more exposed to the risks and uncertainties in those markets. It bears mention, of course, that Delmarva does not own generation now and does not plan to during the rate-effective period, but it does compete for capital with companies that do own generation.

Electric utilities will also be more exposed to regulatory risks, since a significant expansion of capital spending by electric utilities usually results in rate proceedings to recover the costs associated with that capital. As a result, regulatory exposure has become a key focus for investors as utilities face a series of rate cases in order to recover the required costs they are incurring to supplement and replace aging infrastructure, to meet environmental requirements, and to meet other costs. These risks are in addition to the other risks posed by the technological, economic, environmental and other policy changes that also affect the industry. It is because of these increased risks that investors no longer perceive electric utilities as a group as being the "safe havens" they once were.

17. Q: <u>Have investors' goals for utility investments changed in response to these increased risks?</u>

A: No. Investors' goals for electric utility investments have not fundamentally changed. They still look to electric utilities primarily as defensive investments, and still look for stable performance and regular dividends as the reason to invest in electric utilities. But investors also

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[2] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

understand that the investment risk in electric stocks has risen significantly, and their expectations of returns have changed accordingly.

In the end, investors have a very large universe of stocks from which to select; with few exceptions, they have no requirement to own electric utility stocks. To the extent that they do invest within the utility sector, investors must be discriminating in their stock selection. As a result, utilities with strong financial metrics operating in constructive regulatory environments will have stronger investment appeal than utilities with weak metrics and less favorable regulation.

18. Q: <u>How do investors view state regulation in the context of a major capital expenditure cycle?</u>

A: Nationally, in the past several years, rate case filings in the electric industry have become much more frequent. From an investor's perspective, each regulatory proceeding introduces a period of uncertainty for a utility. Among the unknowns are the ROE the company will be given the opportunity to earn, the equity base upon which that return can be earned, the extent to which costs—both historical and future—can be recovered, and the degree to which the rate case will prompt a negative regulatory reaction. In other words, the utility's future earnings power is thrown into question until the case is decided. Because that earnings power is the basis for an investment in the company, the stability and constructiveness of state regulatory policies are critical concerns to investors.

19. Q: <u>How are the foregoing uncertainties relevant to transmission and distribution (T&D) utilities such as Delmarva?</u>

A: A number of the factors discussed above are relevant to the Company. In this proceeding, for example, elements that investors will focus on include cost recovery, the equity component of capital structure, and of course the ultimate ROE that is allowed.

20. Q: <u>Please address how investors assess the specific risks the Company is facing in relation to the new capital investment cycle.</u>

A: Investors understand that Delmarva is involved in the industry-wide construction and capital investment cycle. Pepco Holdings Inc.'s (PHI) three utility subsidiaries have a five-year operating electric construction forecast of $5.2 billion, excluding expenditures for Advanced Metering Infrastructure technologies and the Mid-Atlantic Power Pathway. Delmarva accounts for almost 29% of that total, with planned investments in Delaware of $1.5 billion over the 2012-2016 period. During this period, both PHI and the Company will need to access the capital markets. Delmarva (and its parent, which supplies it with equity) will thus be exposed to market vicissitudes and pricing levels.

21. Q: <u>Does the Company face further risks?</u>

A: Yes. With its planned capital spending, it is clear that Delmarva will face regular rate cases. Recovery of the substantial costs of maintaining, renewing, expanding and replacing a mature utility infrastructure is likely to require base rate cases routinely during the coming years.

22. Q: <u>Are investors concerned about regulatory lag in regard to Delmarva?</u>

A: As noted in a report from Regulatory Research Associates (RRA), Delaware regulatory practice uses an average original-cost rate base for a test period that is partially forecast at the time of filing. Known and measurable adjustments to the test year data are permitted.[3] It bears mention that RRA recently lowered its rating of Delaware regulation, in part because of ongoing regulatory lag:

> Regulatory lag has become a persistent problem over the last few years, as the utilities have ramped up capital spending to comply with environmental and reliability requirements. The PSC does not allow fully forecasted test years, and consequently, Delmarva has consistently had difficulty earnings its authorized return, despite regular rate case activity. In addition, recent return authorizations have been somewhat below prevailing industry averages when established. In light of these considerations, we are lowering our rating of Delaware regulation to Average/2 from Average/1.[4]

In the instant proceeding, the test period is December 31. 2011, incorporating six months of actual and six months of projected data. While the forecast component of the test period is supportive of the Company's ability to earn the ROE authorized by the Commission, the six months of actual data will prevent Delmarva from being kept fully whole. As a result, investors will have questions about the timing and certainty of the utility's cash recovery of costs. It is thus reasonable to expect investors to increase somewhat the risk premiums they would require to supply the Company with capital, given this regulatory structure.

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[3] Regulatory Research Associates. "Delaware Public Service Commission." Referenced section updated September 15, 2011.

[4] *Id.*

vulnerable because of their capital-intensive nature and the magnitude of the construction expenditures they now face.

25. Q: <u>How has the financial crisis affected the industry?</u>

A: With the demise of a number of investment and commercial banks, coupled with the significant weakening of surviving institutions, access to capital was initially difficult for most companies and impossible for others. Indeed, for a period of several weeks in September 2008, the debt markets were completely closed to any company. While some stability has returned to the capital markets, the unprecedented volatility and uncertainty that has characterized the markets since the fall of 2008 negatively impacted the terms and increased the cost of capital.

In this environment, set in the context of rising capital expenditures for the industry at large and the Company specifically, it is important that the Commission recognize that investors require a level of return that reflects the increased level of risk.

26. Q: <u>What are the regulatory implications of this financial crisis?</u>

A: The current environment presents a distinct challenge to the utility industry. The industry must retain access to capital on reasonable terms during this period of market uncertainty in order to provide safe and reliable service to customers. This will require balanced and consistent regulation. Maintaining a solid regulatory compact will be critical.

27. Q: <u>Please elaborate on your use of the term "regulatory compact."</u>

A: The regulatory compact means that utilities will take the risk to invest in the infrastructure and assets needed to provide safe, reliable and efficient electric service, and that regulators will support that investment by providing timely recovery of costs, reasonable returns on prudently invested capital, and regulatory treatment that, in general, is fair, predictable and balanced. It does not involve favoring any one group of interested parties in the regulatory process over others, but recognizes the key relationship between investment of capital by the utility, and the need for recovery of operating costs, capital and returns to support prudent investment.

28. Q: <u>Are the Company's current credit ratings cause for concern in its ability to obtain access to the capital markets?</u>

A: Yes. As previously discussed, the turmoil in the financial markets has resulted in no company — no matter how financially strong — having carte blanche access to debt and equity financing. The stronger the company, the better the odds that financing would be available, but there are no guarantees. As will be discussed later, all three credit rating agencies currently have a stable outlook on the Company. However, a variety of circumstances, including a lack of regulatory support, could cause that perspective to change negatively.

29. Q: **<u>What factors suggest that improvement may still be slow to come in the economy, with attendant negative implications for the markets?</u>**

A: News sources contain articles on almost a daily basis conveying that the economy is still in a recovery mode and the opportunity for additional shocks to the system exists. For example, the Federal Reserve Board's recent continuation of its accommodative monetary policy, heretofore an important stabilizing force in the markets, is serving to foster increased concerns about the mounting size of the federal deficit as well as its impact on the dollar relative to other currencies. Indeed, as its program of Quantitative Easing was drawing to a close in June, the Federal Reserve Board acknowledged that it would be faced with a delicate balancing act of maintaining a weak but rebounding economy while not fueling inflationary pressures in the process. The magnitude of the federal deficit has also fostered significant concern among other countries in terms of the level of the dollar versus their currencies. And, importantly, the level of the deficit and Congress' seeming inability to find a palatable solution to reducing it prompted rating agency Standard & Poor's (S&P) to lower the U.S. credit rating—a pristine AAA since its rating inception in 1917—to AA+. This downgrade served to reinforce the existing skepticism regarding the sustainability of the economic recovery. While fellow credit agencies Moody's Investors Service (Moody's) and Fitch Ratings (Fitch) did not echo S&P's move at the time, Moody's warned it could take negative action prospectively.

Another major problematic area is commercial real estate, which has billions of dollars of loans coming due and limited prospects of repayment. A crisis in this area could exacerbate ongoing problems in the already weak banking sector. And the possibility of markets being disrupted by unanticipated events from around the world always exists, and has been a meaningful negative factor recently. Serious concerns exist over the sovereign debt of a number of the European nations—in particular, Greece at the present time. In tandem with these debt worries is the significant question of whether the Euro market will survive. In short, given the unstable economic and political backdrop that still exists globally, there are numerous possibilities for circumstances and/or events that could plunge the financial markets back into a crisis mode. In sum, substantial risk still exists.

III. INVESTORS' EXPECTATIONS FOR RETURNS AND PERCEPTIONS OF THE CURRENT PROCEEDING

30. Q: <u>Why is the perception of regulatory climate of such importance to investors?</u>

A: Equity investors today still seek companies that can offer stability in earnings and dividends. Fixed income investors look for stable and adequate cash flows to ensure payment of principal and interest when due, as indicated by stable credit ratings. The ability to pay dividends and sustain credit ratings is directly related to the consistency and sufficiency of a utility's earnings, which depend in large part on how the utility is regulated and managed. If there is uncertainty about whether regulation will allow a utility the opportunity to earn a reasonable return in future years, then that lack of predictability will lead investors to avoid holding investment positions in the utility, all other things being equal.

As a result, investors selecting electric utility stocks today place a very high value on consistent and constructive regulation. And, with a new round of base rate case filings underway in the industry, the quality of regulation is receiving increased investor scrutiny.

31. Q: **<u>In your experience as an analyst and portfolio manager, could a perceived change in a company's regulatory climate affect your investment opinion?</u>**

A: Absolutely. During my tenure as an institutional investor, a utility's regulatory environment was a critical factor in my assessment of its investment attractiveness. An adverse regulatory decision could be a key determinant in my recommendation or decision to sell a stock already owned or not to make an investment in one under consideration.

32. Q: **<u>Who are typical investors in utility stocks?</u>**

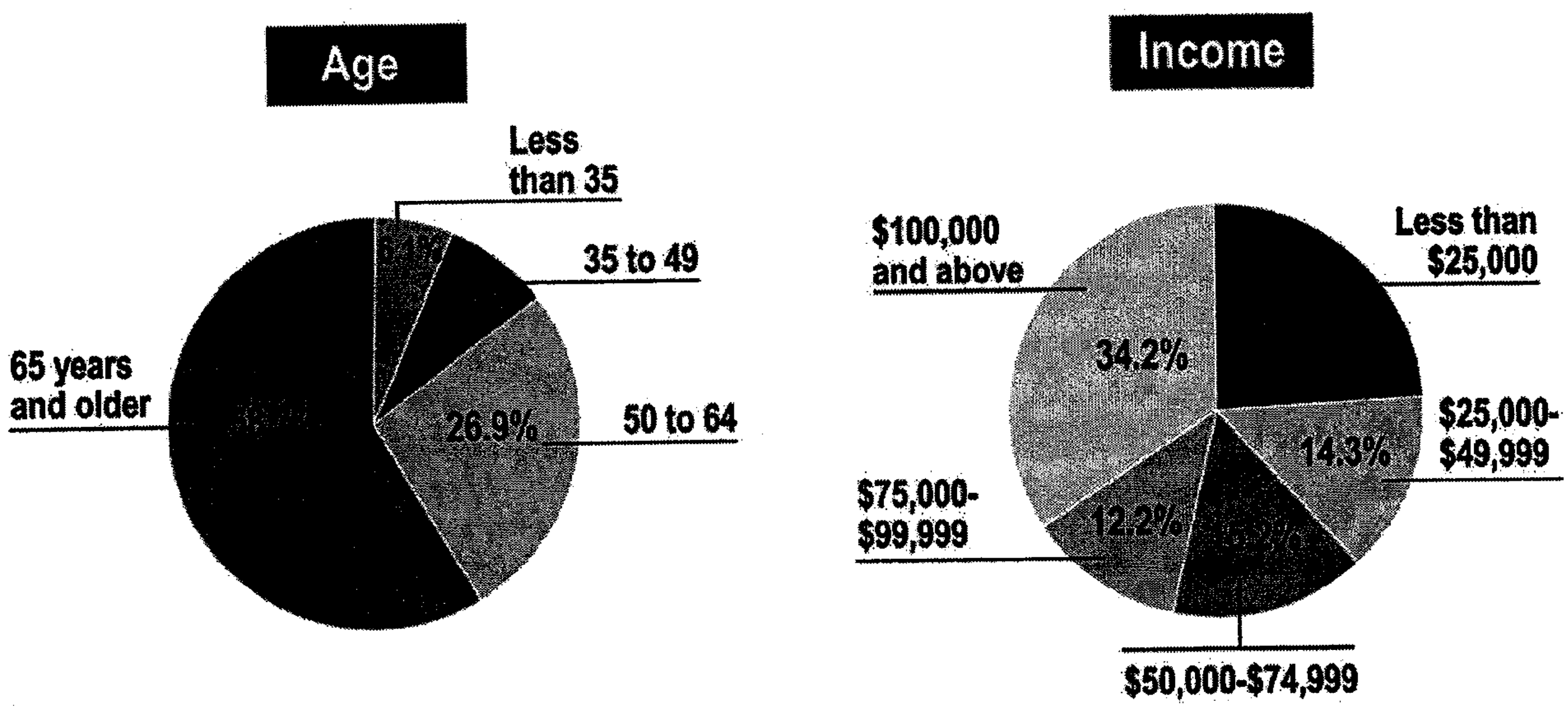
A: There are two kinds of investors: individuals, who generally seek stability and income from their utility holdings, and institutions, which generally seek total return (i.e., price appreciation plus dividend income) from their utility investments.

33. Q: **<u>Please provide more detail on individual investors.</u>**

A: Individuals can own stocks through two avenues: either outright in his or her own name, or through a variety of institutional vehicles. In the latter option, which will be discussed later, a person purchases shares in a mutual fund or other investment vehicle or has a direct interest in a pension fund that is managed by professional or institutional investors.

As noted previously, individual investors typically seek stability and income in their utility holdings. According to a recent study authored by Ernst & Young[5], the individual who directly owns utility stocks is older and not in the highest income bracket. Using the Internal Revenue Service's Statistics of Income on tax returns with qualified dividends and information from a variety of sources on investors' portfolio holdings, Ernst & Young estimated the age and income distribution from direct investors in utility stocks in 2007 as follows:

Tax Returns with Qualified Dividends from Direct Utility Stocks, 2007



Note: Totals may not add up due to rounding.

As the foregoing charts illustrate, 86% of the outright owners of utility stocks are aged 50 and older; 59% are aged 65 and older; 66% have incomes of less

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[5] Ernst & Young. The Beneficiaries of the Dividend Tax Rate Reduction: A Profile of Utility Shareholders. Prepared for the Edison Electric Institute and the American Gas Association. January 2010.

than $100,000; and 38% have income less than $50,000. These data suggest that the typical owners of utility stocks are older individuals who hold utilities to supplement their retirement income.

34. Q: **<u>Can you provide a profile of Delaware residents who own shares of PHI stock?</u>**

A: As of September 30, 2011, there are almost 227 million shares of PHI common stock outstanding that are held by over 53,700 shareholders. Of that total, 3,309 shareholder accounts, representing 2,018,434 million shares, are registered directly to Delaware residents. Thus, 6.2% of total PHI shareholders and 1.0% of total PHI shares reside in Delaware. And, as discussed previously, individual shareholders have a high dependence on dividend income.

35. Q: **<u>What are the implications of these demographics for individual investors in utility stocks?</u>**

A: Because the vast majority of utility individual shareholders are older and desirous of supplemental income, it is important for utilities to produce strong earnings that can support the dividend income that these holders need. As will be discussed later in greater detail, PHI currently offers a very competitive dividend yield to shareholders. The common dividend has not been increased since January 2008 and the payout constitutes a disproportionately high percentage of earnings at the present time. However, if the Company had the ability to earn its authorized ROE, its dividend payout would be more in line with the industry average.

36. Q: <u>Turn now to institutional investors. Has the investment industry itself changed in recent years?</u>

A: Yes. In recent years, institutional investors and hedge funds have grown dramatically in the amount of capital they control. This growth has had a significant impact on the speed with which the market reacts to unfavorable developments. It has led the market to be much more reactive and much less forgiving than it may have been in the past. In the context of a regulatory decision, investors will not necessarily wait, as they would have in the past, to see how the ramifications of a decision might play out. Rather, they simply sell their shares if a regulator's decision runs counter to their expectations.

37: Q: <u>Why are institutional investors of such importance generally?</u>

A: Because of the sheer size of their investment positions, institutions can influence the course of individual securities, and sometimes can move the market as a whole. Institutional investors include financial institutions such as various types of public retirement funds, mutual funds, investment companies, insurance companies, and commercial and investment banks. They approach the investment selection process from the standpoint of a portfolio. An investment portfolio is a collection of stocks selected to achieve the highest possible return within a commensurate level of risk. Therefore, institutional investors keep electric utilities in their portfolios only when such stocks contribute to achieving the desired risk/return relationship.

It should be remembered that, generally, the customers of institutional investors are individuals and it is they who ultimately gain or suffer loss from changes in the value of the institution's investments. Anyone who has a stake in a retirement plan, owns a mutual fund, has a trust fund, or pays insurance premiums, for example, is directly or indirectly a client of an institutional investor. The individuals who make the decisions concerning these investments, however, are paid money managers, and how they see their responsibilities to the clients they serve, and the way that their performance is judged, have a great deal to do with how they react to developments in the market.

38. Q: <u>Why are institutional investors important to Delmarva?</u>

A: Institutional investors today hold roughly 56% of parent company PHI's total common shares. Such investors warrant significant attention due to their ability to change dramatically the market for the parent shares. Because institutional investors own large blocks of shares relative to the volumes typically traded, their activity in moving in or out of a company's shares is often noticeable as a significant change in the price and volume of shares being traded for a company. This change may be picked up by other institutional investors, by the investment community in general, and eventually by individual investors. These other entities will then look to see what is driving this trend in the stock and whether the trend is likely to continue or disappear. If they see support for the trend, they may follow the lead of the firms that initially began to move the market, and by following the leaders, the late movers may further strengthen the trend.

39. Q: Why might an institutional investor choose not to hold investments in a particular electric utility?

A: Several factors might be drivers. First, institutional investors have fiduciary responsibilities. For example, managers of pension assets fall under Federal Employee Retirement Income Security Act of 1974 (ERISA) laws, which mandate that a portfolio manager's decisions meet the so-called "prudent man" standard. That is to say, he or she is expected not to make investment decisions that are unduly risky or to retain stocks that are unduly risky given the investment goals of the portfolio and the function of the stock within it.

In addition, institutional investors have performance pressures. It is not enough for stocks in a portfolio simply to increase in value. Relative performance is what counts. Investment performance is gauged against the returns earned by a market proxy (such as the S&P's 500 Index) or a peer group of investments (i.e., those with a similar style, such as value, growth, growth & income, small cap, etc.). Mutual fund rating organizations such as Morningstar track and publicize the relative performance for mutual funds, while various pension consultants perform the same service for their client organizations.

40. Q: What happens when an institutional investor underperforms?

A: The results can vary, but, eventually, underperformance will result in lost business and personnel changes. Mutual fund shareholders can sell their fund shares. A pension plan sponsor can fire the professional investor or reduce the assets under its investor's management. And, of course, poor performance also disadvantages the individual who has entrusted his monies to the institution for management.

41. Q: <u>How long a period does an institutional investor have before performance becomes an issue?</u>

A: Again, it can vary. But there is little argument that institutional investors no longer have the luxury of a long time horizon in which to show performance. Investors need and want results. And, with the public visibility that investment results now have (through organizations such as Morningstar and the various pension consultants) and the resulting performance pressure, most investment organizations are now operating with a much shorter time horizon than in years past. Generally speaking, a long investment time horizon today can be as short as 12 to18 months. A stock that is unlikely to perform within the prescribed time horizon is usually not attractive for purchase or continued investment by an institutional investor.

42. Q: <u>What does this mean for investments in regulated utilities specifically?</u>

A: This shortened time frame means that, if there is bad news, institutional investors are more likely to react quickly. In the instance of a rate proceeding, these investors are unlikely to wait to see what the outcome of the next rate decision will be. That would represent an opportunity cost to them. Rather, institutional investors would be more prone to sell their shares on the news of an adverse regulatory outcome. This would not be good for customers either, for the reasons discussed earlier.

43. Q: <u>How have you gauged investors' perceptions of the issues in this proceeding?</u>

A: To supplement my own knowledge of the industry, I have reviewed various reports related to the Company and its parent written by investment analysts. A clear picture of investors' perceptions emerges from these reports, which is in keeping with my own views.

44. Q: <u>Please discuss investors' general views of regulation.</u>

A: One of the key factors analysts use to evaluate the quality of a regulatory climate is the consistency of a commission's decisions. Investors value certainty and predictability; a lack of consistency in a commission's actions or decisions serves to increase the investment risk associated with a utility. Where there is a predictable track record of regulatory decisions and actions, investors are able to anticipate reliably the future actions of a commission. That reduces risk and supports reasonable valuations—i.e., the market supports a higher price for the company's stock and a lower interest rate on bonds, which decreases a company's cost of capital.

In a study I prepared in 2005 for EEI on investors' perceptions of state regulation[6], respondents were asked to cite the regulatory factors they felt characterized a constructive environment, as well as those that characterize a non-constructive environment. On the positive side of the ledger, one of the most important considerations for investors was a regulatory climate that is "fair, stable, predictable, and consistent."

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[6] J.M. Cannell, Inc. <u>State Utility Regulation: An Assessment of Investor Perceptions</u>. Prepared for the Edison Electric Institute. August 2005.

45. Q: <u>**Turn now to the viewpoint of credit rating agencies. Please comment on how the agencies perceive the Company and its regulatory situation.**</u>

A: Delmarva's credit ratings are all investment grade. The Company's long-term issuer ratings/unsecured debt ratings are BBB+, Baa2, and BBB+ from S&P, Moody's, and Fitch, respectively. All three agencies have a stable outlook on the Company.

46. Q: <u>**What role do credit agencies play in investors' expectations?**</u>

A: In the wake of financial disasters, bankruptcies, and the ensuing severe erosion in investor confidence that began early in this decade, credit issues became critically important not only to fixed income investors, but also to equity investors. While credit downgrades initially impacted only the most troubled companies, a spillover effect soon was experienced by healthy utilities. Part of this was due to the fact that the rating agencies came under harsh criticism that they had failed to detect problems early enough in companies such as Enron Corp. As a result, they began to heighten their scrutiny of all entities under their watch and became far more proactive in making rating changes. "Headline risk" also began to come into play, as investors worried that—when credit problems in an industry are in the headlines—any company in the sector could be vulnerable to a downgrade. Thus, equity investors now closely watch the actions of the credit agencies because any change in ratings can signal underlying problems and have a significant impact on a company's stock price.

47. Q: **<u>Why is having an investment grade credit rating important?</u>**

A: In simple terms, the higher the credit rating, the greater the access to debt capital and the less it costs to borrow. In turn, lower borrowing costs translate into lower customer rates. On a slightly more complex level, when a debt rating nears or enters non-investment grade or "junk" status, interest costs begin to rise significantly because lenders need a higher return as compensation for the much higher risk they are incurring. It bears mention that credit rating downgrades occur more readily than do upgrades. Further, when a credit rating is officially non-investment grade, many financial institutions are no longer permitted to hold the bonds of the company in question. That company's debt is considered to be unsafe and thus unfit for inclusion in conservative investment portfolios.

48. Q: **<u>Please comment on the impact a non-investment grade credit rating has on market access.</u>**

A: When a company is rated below investment grade, not only does it have to pay more for its debt, but also its access to the credit markets is also fragile and uncertain. This is particularly true during times of heightened market instability, when investors tend to gravitate toward investments that are of a higher quality and thus perceived to be safer. Unfortunately, it is often during tumultuous periods that a company's need for credit is heightened, and it is at just those times that the credit spigot can be closed off. In more extreme situations, that lack of credit availability can cause a company's financials to spiral out of control, potentially resulting in bankruptcy.

The impact of a non-investment grade credit rating or the worst-case setting of a bankruptcy has a very adverse impact on customers. Because financing expense is a legitimate cost of service, customer rates must rise to reflect those higher costs. But, equally important, the company operations can be negatively impacted if a company is forced to take measures to conserve available cash.

49. Q: <u>Why is a utility's regulatory environment important to the rating agencies?</u>

A: The rating agencies appraise companies on the basis of creditworthiness. Rating agencies also evaluate current financial soundness and attempt to discern how that might change in the future. One of the key factors in assessing a utility's financial picture is the regulatory climate in which the company operates, because regulators influence the utility's capital structure and establish allowed returns that may be earned on that capital. Thus, a regulatory environment characterized by consistency and predictability is one that lends itself to a company having a sounder financial base. Conversely, a regulatory situation defined by a lack of stability can have a deleterious impact on a utility's credit profile.

50. Q: <u>Please discuss Moody's ratings on Delmarva.</u>

A: The agency's assessments fit within the framework of its ratings method, in which the key factors it examines in its ratings are articulated and quantified.[7] Regulation is clearly of paramount importance: "regulatory framework" and "ability to recover costs and earn returns" each carry a 25% weighting. The other ratings factors are diversification (10%) and financial strength and liquidity (40%).

51. Q: <u>Please elaborate on Moody's views regarding "regulatory framework."</u>

A: Moody's notes that "the predictability and supportiveness of the regulatory framework" in which a utility operates is a "key credit consideration." The agency has said it examines various factors of a regulatory environment, including "how developed the regulatory framework is; its track record for predictability and stability in terms of decision making; and the strength of the regulator's authority over utility regulatory issues. A utility operating in a stable, reliable and highly predictable regulatory environment will be scored higher on this factor than a utility operating in a regulatory environment that exhibits a high degree of uncertainty or unpredictability."[8]

52. Q: <u>What about the second regulation-related factor, "ability to recover costs and earn returns?"</u>

A: Moody's states that "the ability to recover prudently incurred costs in a timely manner is perhaps the single most important credit consideration for regulated utilities, as the lack of timely recovery of such costs has caused financial stress for utilities on several occasions." The agency pointed to the

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[7] Moody's Electric Service, "Rating Methodology: Regulated Electric and Gas Utilities." August 2009.

[8] *Id.*

fact that regulatory disputes that ended in insufficient or delayed rate relief were a factor in four of the six major investor-owned utility bankruptcies in the United States over the last 50 years. Moody's also opined that "currently, the utility industry's sizeable capital expenditure requirements for infrastructure needs will create a growing and ongoing need for rate relief for recovery of these expenditures at a time when the global economy has slowed."[9]

53. Q: <u>Does Moody's identify regulation as being among the drivers of the agency's ratings of the Company?</u>

A: Yes. The agency cites "operates in challenging regulatory environments" as a ratings driver.[10]

54. Q: <u>Please elaborate.</u>

A: Moody's notes that the Company's regulatory environment is the key factor influencing its ratings. The agency explains that it "views the Delaware regulatory environment cautiously but sees improvement evidenced by movement (albeit slow) toward implementation of a decoupling rate mechanism." In regard to Delmarva's regulatory environment, Moody's scores the Company a high Ba, stating that both the Delaware and Maryland regulatory jurisdictions provide adequate cost recovery mechanisms. As to Delmarva's ability to recover costs and earn returns, Moody's assigns a Baa score, explaining that the score "also takes into consideration the fact that DPL has historically earned less than its allowed return." The agency did,

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[9] *Id.*

however acknowledge that both of the Company's regulatory jurisdictions "provide adequate cost recovery mechanisms."[11]

55. Q: <u>Did Moody's discuss its expectations regarding its outlook on the Company, or factors that could change the current rating?</u>

A: Yes. The agency stated that its stable outlook on Delmarva is predicated on the Company's continuing to "maintain an adequate financial profile as it begins to undertake a large capital spending program and that future distribution rate case filings will be constructive." While Moody's envisions no upgrade for Delmarva because of its cautious view of the Company's regulatory climate, a downgrade could be forthcoming if financial metrics weaken considerably or "if the regulatory environment in which it operates becomes openly hostile."[12]

56. Q: <u>What do you infer from Moody's observations about Delmarva?</u>

A: The agency is aware of the Company's significant capital expenditure program and the constructive regulation needed to support it. While Moody's currently is sufficiently comfortable with Delmarva's regulatory environments due to adequate mechanisms for cost recovery and, in the case of Delaware, progress toward implementation of rate decoupling, the agency warned that a downgrade could occur if the tone of regulation becomes destructive.

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[10] Moody's Investors Service. "Credit Opinion: Delmarva Power & Light Company." July 25, 2011.
[11] *Id.*

57. Q: <u>What is Fitch's perspective on the Company?</u>

A: In a recent affirmation of Delmarva's and sister companies' Potomac Electric Power Company's and Atlantic City Electric Company's ratings, Fitch addressed the utility's regulatory environment:

> While the states in which they [Pepco, DPL, and ACE] operate are considered fairly constructive, the utilities have consistently not earned their allowed returns and have had significant regulatory lag. Management has had renewed focus in recent years to improve both regulatory relationships and their operational performance in order to reverse this trend. Execution of this strategy will be a key driver of PHI's risk profile going forward.[13]

The agency further noted that, due to Delmarva's aggressive capital expenditure program, it expects the Company's credit metrics to "weaken somewhat over the forecast period yet remain consistent with DPL's 'BBB+'" issuer rating.

58. Q: <u>Does Fitch have any regulatory-related hesitation regarding the Company?</u>

A: Yes, it does:

> Fitch expects DPL to continue to file rate cases every 18-24 months to overcome the regulatory lag.[14]

As noted previously, the agency points to the need for Delmarva to reduce regulatory lag and make progress toward earning at the allowed return level as an important component of the Company's prospective risk profile.

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[12] *Id.*

[13] Fitch Ratings. "Fitch Affirms Pepco Holdings, PEPCO, Delmarva Power & Light, and Atlantic City Electric Ratings." August 3, 2011.

[14] *Id.*

59. Q: What is S&P's outlook for the Company?

A: The rating agency expressed its expectation that the current stable outlook will be sustained due to PHI's "focusing on the three regulated T&D utilities and not increase unregulated operations beyond a nominal contribution to consolidated operating income."[15] Consistent with that view, S&P further expects a strengthening in cash flow protection and debt leverage measures along with an increase in utility cash flows and a decline in consolidated debt levels.

60. Q: How does S&P view the Company's regulatory environment and outlook?

A: In enumerating Delmarva's weaknesses, S&P included "less credit-supportive regulatory environments" as a factor. The agency expanded on that assessment by opining that such regulatory environments require "diligent management of regulatory relations and rate recovery." S&P also opined that it expects parent PHI to "reach constructive regulatory outcomes to avoid any meaningful rises in business risk." The agency noted that it could change lower ratings if, among other factors, "expected rate recovery is less than expected, or financial measures do not achieve our expected levels on a sustained basis."[16]

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[15] Standard & Poor's. "Delmarva Power & Light Co." July 27, 2011.
[16] *Id.*

61. Q: **<u>What inferences do you draw from the credit rating agencies' views of Delmarva and its regulatory environment?</u>**

A: Moody's evaluates companies within an articulated ratings methodology. Of the four factors the firm reviews, the regulatory framework and ability to recover costs and earn returns account for half of the evaluation. Specific to Delmarva, Moody's views the Company's regulatory environment cautiously, though notes that the jurisdictions provide adequate cost recovery mechanisms. The agency believes that constructive rate cases will be important prospectively, given the large capital spending program that lies ahead. Fitch, while viewing Delmarva's regulatory environment as being fairly constructive, expressed concern over the Company's regulatory lag and consistent inability to earn its allowed return. The rating firm expects Delmarva's credit metrics to weaken somewhat. S&P, like Moody's, views Delmarva's regulatory environment as being less credit supportive, which will require a pronounced emphasis on regulatory relations and management of rate cases. The agency indicated that one of the reasons the Company's rating might be lowered would be if actual regulatory outcomes were below expectations. In sum, the three agencies have a somewhat divergent opinion about Delmarva's regulatory climate, but agree that supportive regulation will be necessary prospectively.

62. Q: <u>Please turn your attention now to the opinions of equity investors. How do they view the Company?</u>

A: Analysts are keenly aware that PHI in mid-2010 completed the sale of its merchant generation assets and can now fully focus on its regulated utilities. With those operations expected to provide 90 to 95% of the corporation's earnings prospectively, investors are placing a renewed emphasis on the company's regulatory environments. They also view PHI's dividend as an investment attribute, particularly given the opportunity present with stronger earnings growth ahead to reduce the above-average payout ratio.

63. Q: <u>You previously discussed the importance of the dividend to individual investors in utility stocks. Is the dividend also important to institutional investors?</u>

A: Yes. While individual investors primarily seek the additional income that a utility dividend affords them, institutions focus on total return, which is comprised of appreciation in the price of a stock along with dividend income. In the case of PHI, the $1.08 per share annual dividend rate currently represents a payout greater than the $0.91 earned in 2009 and a high proportion (87%) of 2010's earnings of $1.24. That high payout provides a very attractive dividend yield, which is in excess of that available from most utility and other investments. Institutions understand that a dividend rate that exceeds or constitutes the lion's share of earnings is not sustainable. In PHI's case, however, the expectation is for the dividend to be maintained, and for earnings to grow into the dividend rate. As JP Morgan noted:

> 71%-74% by 2013. The potential decline in the dividend payout should instill considerable investor confidence in the attractive dividend. Therefore, in our opinion, the company's dividend is secure and the level of security should improve materially over the next five years. The current indicated dividend of $0.27, $1.08 provides a current indicated yield of over 6.0%, attractive relative to nearly all peer utility stocks, and certainly relative to the broad market, and Treasury yields, in our view.[21]

64. Q: **<u>Why should PHI's dividend be maintained and not reduced or omitted?</u>**

A: Because both individual and institutional investors place great value on PHI's dividend, a reduction in or omission of the payout would remove a strong rationale for an investment in the company. A negative dividend action would be particularly ill-advised during this period of high capital expenditures for PHI and its utility subsidiaries. Just as some debt investors are prohibited from owning non-investment grade credits, some equity investors have dividend income as a mandatory investment criterion. Further, as previously noted, individual investors in PHI's stock have come to rely on the income produced by their investment. A reduction of PHI's dividend would be a particular hardship to those lower income investors on fixed incomes. In short, maintaining PHI's dividend at its current level is critical to the company.

[21] Wellington Shields & Co. LLC. "Pepco Holdings, Inc.; Reducing Estimates Modestly, Prospective Growth and Stock Remain Attractive." March 17, 2011. The acronym "EPS" refers to "earnings per share."

65. Q: <u>You indicated previously that investors expect the dividend to be maintained. Has any concern been expressed in this regard?</u>

A: Yes. As will be discussed below, fair regulatory treatment of PHI's utility subsidiaries in the near term will be important to dividend sustainability.

66. Q: <u>Is PHI's dividend also important to customers?</u>

A: Yes. On November 17, 2010, the National Association of Utility Regulatory Commissioners (NARUC) adopted a Resolution urging Congress to retain the existing lower dividend tax rates that were due to expire on December 31, 2010.[22] In its Resolution, NARUC made the following points regarding utility dividends:

- Raising dividend tax rates would make it more difficult for dividend-paying companies to attract investors. This is especially true for the extremely capital-intensive electric utility industry.
- Infrastructure projects created by utilities are an important source of high-quality jobs that will help keep America competitive.
- The higher cost of capital driven by higher income taxes on dividends, combined with utilities' need for extremely large amounts of capital, *will translate into higher utility customer rates*. (Emphasis added)

The regulators' points about utility dividends in general are also true for PHI specifically.

67. Q: <u>In addition to the infrastructure investments cited by Oppenheimer, what other factors do analysts consider important in helping grow earnings and further secure the safety of the dividend?</u>

A: Regulation is a frequently cited factor.

[22] National Association of Utility Regulatory Commissioners. "Resolution Urging Retention of the Lower Dividend Income Tax Rates." November 17, 2010.

68. Q: <u>Please elaborate.</u>

A: As noted previously, regulation is a critical element in determining the ROE a utility is permitted and its ability to actually achieve it. The dividend payout is an outgrowth of the earnings level. The investment firm Edward Jones noted in its research its belief that future rate increases will help to support the dividend and thus lower the risk of its being reduced. Wunderlich Securities confirmed the importance of regulation to earnings: "Earnings growth in '11 and '12 is driven largely by rate increases in regulated operations."[23] The firm recently affirmed that viewpoint: "As expected, recent rate increases had a significant impact on earnings."[24]

Barclays Capital raised a warning flag regarding the importance of regulation to the dividend. After the announcement late last summer of a delay in the Mid-Atlantic Power Pathway (MAPP) transmission line, which will result in lower short-term expected earnings for PHI, the firm noted that constructive regulatory outcomes in the near-term will be especially important in the context of financial support for the dividend:

> **While delay is at least $0.08-$0.10 dilutive, we don't think POM cuts dividend:** While we see POM keeping its dividend ($1.08), this does put increasing emphasis on its rate case decisions. With several key outcomes coming over the next 12-18 months, POM needs fair regulatory treatment or we will begin to be more concerned about dividend sustainability.[25]

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[23] Wunderlich Securities. "Pepco Holdings, Inc.: 2Q EPS Better Than Expected; Increase Estimates and Maintain Hold." August 10, 2010.
[24] Wunderlich Securities. "1Q Better Than Expected; Raise Estimates and Target Price." May 9, 2011.
[25] Barclays Capital. "Pepco Holdings: MAPP Likely Not In Service Until '19-'21." August 19, 2011.

69. Q: <u>Can you be more specific on investors' views regarding the Company's regulatory situation?</u>

A: Yes. In addressing the subject of regulation as it pertains to Delmarva and its parent, PHI, analysts' comments revolve around several topics: regulatory risk in general, regulatory lag, regulatory mechanisms, allowed ROE levels, and state/case-specific commentary.

70. Q: <u>Please discuss analysts' views of general regulatory risk associated with the Company and its parent.</u>

A: Any utility falling under the jurisdiction of a state regulatory body will obviously be impacted by the rulings of that commission. The potential for regulatory risk is thus common to any regulated utility. The degree to which that factor is pronounced is determined by the quality of the regulatory environment. In the case of PHI, analysts have some general reservations about the quality of the regulatory climates in the states in which the parent's subsidiaries operate, with some describing the company's collective regulatory environment as "challenging" and having "room for improvement." Oppenheimer, however, singled out New Jersey (and Delaware) as being "fairly constructive," with the expectation that commissions in those states would not be "unreasonable in assessing utility investments and establishing returns on the investments."[26] Investors are keenly aware of how critical constructive regulation is to PHI's and its subsidiaries' financial health. As Oppenheimer noted, "In our view, creating and maintaining a constructive regulatory environment and reasonable rate case outcomes are key to playing out PHI's strategy successfully."[27] Wellington Shields offers a similar opinion:

> As in all electric utilities, regulatory decisions are critical. The company faces a number of critical regulatory decisions over the next several years that will help shape the fundamental outlook for the company. Regulatory outcomes are never more important than when a company is expanding aggressively. The company must achieve satisfactory regulatory outcomes on a timely basis to avoid excessive regulatory lag and weak earned returns. If the various regulators do not approve satisfactory revenue requirements to adequately support Pepco's [PHI's] capital program in a timely fashion, they will adversely affect Pepco's [PHI's] prospective financial performance. Without significant capital tracker/rider support for Pepco's [PHI's] capital plan, this is the one risk we are most concerned about."[28]

71. Q: **<u>You referred to other issues important to investors such as regulatory lag, allowed ROE levels, and regulatory mechanisms. Please elaborate on regulatory lag.</u>**

A: Regulatory lag impedes a utility's ability to earn its allowed ROE. PHI's subsidiaries have several sources of regulatory lag, including, importantly, the absence of regulatory mechanisms that would serve to mitigate the earnings gap. Investors have expressed clear concern that the PHI utilities are subject to large amounts of regulatory lag. For example, Wells Fargo stated: "In addition, the lack of rate riders and forward looking test years make it challenging for the regulated utilities to earn their allowed ROE even immediately after new rates are implemented."[29] Indeed, SunTrust

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[26] Oppenheimer, <u>op. cit.</u>
[27] *Id.*
[28] Wellington Shields. "Pepco Holdings." November 30, 2010.
[29] Wells Fargo Securities. "Pepco Holdings, Inc.: POM: Upgrading Rating to Outperform; T&D Growth Story with Attractive Yield." May 25, 2010.

Robinson Humphrey has quantified its 2011 and 2012 earnings per share estimates of $1.25 and $1.35, respectively, as assuming the sizeable sums of $0.35 and $0.27 of regulatory lag in PHI's utility portfolio in 2011 and 2012, respectively.[30] In other words, the analyst's 2011 EPS estimate would have been $1.60, and the 2012 estimate would have been $1.62, in the absence of regulatory lag.

Wellington Shields provides perhaps the most forceful statement of the deleterious effect that regulatory lag has on the PHI utilities. The firm notes that a persistence of regulatory lag would impair PHI's earnings growth, heighten concerns over dividend safety, and affect the company's access to the capital markets on reasonable terms:

> Should regulatory lag prove onerous during Pepco's [PHI's] construction build-out, it will certainly adversely affect Pepco's [PHI's] ability to attract the debt and equity financing that will be necessary to support the company's construction program on favorable terms. Failing to achieve satisfactory, timely return on Pepco's [PHI's] capital expansion will also affect the dividend. While we are currently comfortable with the direction of Pepco's [PHI's] fundamental prospects and the current dividend, weak earned returns on rate base could slow the improvement in the dividend coverage that will be important to reducing investor anxiety over the high dividend payout ratio and in turn affect the pricing of significant new equity over the next five years.[31]

72. Q: <u>Are investors aware of the Company's efforts to mitigate regulatory lag?</u>

A: Yes. As Barclays Capital, Wunderlich Securities, and Morningstar respectively noted,

[30] SunTrust Robinson Humphrey. "Pepco Holdings, Inc.: 4Q Above Our Estimate Primarily Due to Favorable Tax Treatment." February 28, 2011.
[31] Wellington Shields & Co. LLC, <u>op. cit</u>., November 30, 2010.

> **Reaffirming the regulatory strategy:** POM's message over the last year has been consistent, with a fierce focus on reducing regulatory lag in its jurisdictions. While progress thus far in introducing new mechanisms appears to be relatively slow moving, POM is committed to earning closer to their authorized ROE, even if that entails filing annually or ever more frequently for relief.[32]

> **Regulatory lag continues to be key challenge.** ... Regulatory lag versus allowed returns equates to $0.30 in EPS. It appears POM will be a serial filer of rate cases over the next few years, and while the company intends to seek mechanisms such as trackers and forward test years to help eliminate regulatory lag, our sense is that it will take several rounds of cases to meaningfully reduce this lag.[33]

> On the regulatory front, Pepco [PHI] scores poorly. Efforts to address regulatory lag by establishing reliability investment trackers and automatic annual rate adjustments have been repeatedly shot down by regulators. Barring unexpected regulatory changes, the company will continue to suffer from infrequent rate cases that utilize historical test years.[34]

It bears mention that, in the 2005 Investor Perception study previously referenced in my testimony, investors expressed support for regulatory mechanisms in general. For example, when queried as to which areas of regulatory treatment could bear improvement, over half the analysts' responses referenced regulatory flexibility and mechanisms. As to specific mechanisms, the study sought analyst views on future test years and Construction Work in Progress (CWIP) in rate base. Approximately 83% of respondents endorsed the use of a future (versus historical) test year, and 97%

[32] Barclays Capital. "Pepco Holdings: Q3 Miss but Guidance Raised to Top End." November 4, 2011.
[33] Wunderlich Securities. "Pepco Holdings, Inc.: Tough Outlook for POM; Yield Provides Floor for Stock." April 11, 2011.

supported placing CWIP in rate base.[35] These mechanisms would offer a number of benefits, chief among them greater certainty regarding the recovery of costs. But, importantly, because a greater proportion of expenditures would be recovered in a more timely fashion, these mechanisms would also lengthen the time between rate cases.

73. Q: <u>Please summarize investors' views of the Company and its regulatory environment.</u>

A: Analysts believe that PHI's recent divestment of its merchant generation assets and renewed focus on utility operations will result in improved earnings in the years ahead. The dividend payout, currently very high but expected to decline as earnings grow, provides investors with an appealing level of income. Investors understand that supportive regulation will be needed to ensure Delmarva's financial health prospectively: the allowed ROE will underpin earnings and dividend growth. Regulation is viewed as a risk element for many utilities, including Delmarva and its sister companies. In particular, regulatory lag is a concern for the PHI utilities, due to the absence of effective mechanisms to mitigate that lag. Investors are aware of and endorse the fact that the Company is proposing a number of options to help reduce lag. They are also hopeful that recently allowed subpar ROE levels will increase; this, along with the approval of mechanisms to combat the impact of regulatory lag, should result in a greater opportunity to

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[34] Morningstar Equity Research. "Pepco Holdings." October 5, 2011.
[35] J.M. Cannell, Inc., <u>op. cit</u>.

earn its allowed rate of return. In turn, the safety of the dividend is reinforced. As Morningstar stated,

> We believe regulators will continue to uphold the implicit contract with capital providers that allow shareholders to earn at least their cost of capital on balance, in the long run. In the short term, we expect the shortfall between earned and allowed returns on equity to persist due to continued regulatory lag from infrequent rate cases that utilize trailing test years.[36]

IV. INVESTORS' EXPECTATIONS FOR RETURN ON EQUITY FOR DELMARVA

74. Q: How do you believe that the Company's request for a 10.75% return on equity comports with investors' perceptions?

A: Investors will evaluate any ROE authorized by the Commission in light of a number of factors, including such things as the overall amount of the requested increase that is granted, which bears on the Company's ability to earn the allowed ROE, and whether or not there is a settlement in the case. The fact that an ROE is arrived at through settlement is often seen as a positive factor for investors. In this case, the Company has filed its application seeking a 10.75% ROE, which is higher than the current authorized ROE level of 10.0%, established in January 2011. This filing reflects the rising risk levels in the macroeconomic and capital market environments, as well as recognition on the part of both credit rating agencies and investors that company-specific risks exist. Most importantly, a 10.75% authorized ROE would help maintain the Company's financial health, and assist in maintaining access to the debt and equity capital markets.

[36] Morningstar, op. cit.

75. Q: <u>Could a return on equity award that is consistent with investor expectations also be expected to provide benefits to the Company's customers?</u>

A: Absolutely. A higher ROE permits the realization of a stronger earnings stream. In turn, that can improve a company's stock's valuation prospects, which results in a higher stock price. Thus, when a company needs to tap the equity markets for capital required to meet customer needs, it can get more for its money. Said another way, each share sold brings more equity into a company with the same commitment by the company to generate earnings and pay dividends to support the value of that share. In regard to debt financing, a higher ROE awarded to Delmarva would be viewed as a sign of constructive regulation and would be positive for the Company's credit rating, as strengthened financial metrics could potentially improve the existing credit ratings. Importantly, customers' rates will eventually reflect this lower cost of capital.

<u>CONCLUSION</u>

76. Q: <u>Please summarize what bearing the opinion and expectations of investors have on the current proceeding.</u>

A: This is a precarious time for the electric utility industry. With companies — Delmarva among them — facing continued high levels of construction and other costs, and requiring reasonable access to the capital markets to fund those requirements, supportive regulation is critical. Investors are aware of these factors, and expect the Commission to make decisions in light of them that will enable the Company to meet its investment and other requirements. Current market conditions, current trends in ROE awards, and Delmarva's increased risks support an increase in the last allowed ROE.

77. Q: **<u>Does this conclude your direct testimony?</u>**

A: Yes, it does.

SUMMARY OF TESTIMONY EXPERIENCE
JULIE M. CANNELL

JURISDICTION	CASE OR DOCKET NO.	CLIENT	DATE
Oklahoma	2011-87	Oklahoma Gas & Electric (OGE Energy)	2011
New Jersey	D-ER-11080469	Atlantic City Electric (Pepco Holdings, Inc.)	2011
District of Columbia	FC1087	Potomac Electric Power (Pepco Holdings, Inc.)	2011
Maryland	9249	Delmarva P&L (Pepco Holdings, Inc.)	2010
Vermont	7627	Central Vermont Public Service Corporation	2010
Texas	38480	Texas-New Mexico Power (PNM Resources)	2010
Minnesota	E-015/GR-09-1151	Minnesota P&L (Allete, Inc.)	2010
Pennsylvania	R-2010-2161694	PPL Electric Utilities (PPL Corp.)	2010
Wisconsin	3270-UR-117	Madison G&E (MGE Energy)	2010
South Carolina	D-2009-489-E	South Carolina E&G (SCANA Corp.)	2010
Missouri	ER-2010-0036	Ameren UE (Ameren)	2010
Rhode Island	4065	Narragansett Electric (National Grid)	2009
Colorado	09AL-299E	Public Service Company of Colorado (Xcel Energy)	2009
Massachusetts	DPU 09-39	Massachusetts Electric (National Grid)	2009
Wisconsin	3270-UR-116	Madison G&E (MGE Energy)	2009

JURISDICTION	CASE OR DOCKET NO.	CLIENT	DATE
New York	08-E-0539	Consolidated Edison Company of New York (Consolidated Edison, Inc.)	2008
South Carolina	2007-229-E	South Carolina E&G (SCANA Corp.)	2007
Pennsylvania	R-00072155	PPL Electric Utilities (PPL Corp.)	2007
Virginia	PUE-2006-00065	Appalachian Power Co. (American Electric Power)	2006
Arizona	E-01345A-05-0816	Arizona Utility Investors Association [Arizona Public Service docket]	2006
Texas	32093	CenterPoint Energy	2006
Pennsylvania	R-00061346	Duquesne Light	2006
Washington	UE-060181	Avista Corporation	2006
Oklahoma	PUD 200500151	Oklahoma G&E (OGE Energy)	2005
Pennsylvania	R-00049255	PPL Electric Utilities (PPL Corp.)	2004
South Carolina	2004-178-E	South Carolina E&G (SCANA Corp.)	2004
Nevada	04-6030	Nevada Power (Sierra Pacific Resources)	2004
Connecticut	01-10-10	United Illuminating (UIL Holdings)	2001
Missouri	ER 99-247; ER-99-573	St. Joseph Light & Power	1999
Kansas	97-WSRE-676-MER	Western Resources	1997
Missouri	EM-97-515		
Virginia	PUE960296	Virginia Power (Dominion Resources)	1997